

**Joint OFT/CC Merger Guidelines: has  
anything changed?  
An OFT perspective**

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# Introduction

- **New joint OFT/CC Merger Assessment Guidelines published in September 2010. Explains the Authorities approach to application of the 'substantial lessening of competition' test. Followed significant consultation exercise.**
- **US also issued new Guidelines on horizontal merger assessment late last year.**
- **Presentation will cover some of the changes in the Guidelines and some of the practical implications for OFT**
- **Also look (briefly) at the new exceptions to the duty to refer guidance (October 2010)**
- **Take a 'look ahead' to implications of OFT/CC merger for UK merger control.**
- **Notes:**
  - The views expressed in this presentation are not the official views of the Office of Fair Trading but the presenter's own.
  - References to 'paras' and 'Sections' are to numbered paragraphs/Sections of the UK Merger Assessment Guidelines (September 2010).

# UK merger control assessment: has anything changed?

- **The Guidelines breathe life into a number of principles OFT and CC have been developing over a number of years. Six key areas of change or re-emphasis:**
  - Counterfactual – exiting firm scenario
  - Explanation of Authorities’ interpretation of the term “substantial lessening of competition” (SLC) (outside scope of presentation but see Section 4.1)
  - Nuanced approach to market definition
  - Direct analysis of competitive effects
  - Updated approach to coordinated effects and statement on approach to vertical effects (outside scope but see Sections 5.5 and 5.6 respectively)
  - Clarifying approach to efficiencies (outside scope of presentation but see *Asda/Netto (OFT)*)
- **Other useful documents underpinning OFT approach to merger assessment**
  - Jurisdictional and Procedural Guidance (OFT)
  - Exceptions to the duty to refer Guidance (published October 2010)
  - OFT/CC Joint Commentary on Survey Guidance – explains how to conduct surveys (2010)

## Less emphasis on market definition? (1)

- **Guidelines state:**
  - *“the purpose of market definition is to provide a framework for the Authorities’ analysis of the competitive effects of a merger” (para. 5.2.1)*
  - *“market definition is a useful tool, but not an end in itself, and identifying the relevant market involves an element of judgement. The boundaries of the market do not determine the outcome of the Authorities’ analysis of the competitive effects of the merger in any mechanistic way”*
- **What does this mean in practice?**
- **New guidelines change our approach to market definition.**
  - Old guidelines = apply hypothetical monopolist test.
  - New guidelines = define market in order to provide a useful background for merger analysis. Aim for markets which describe the group of substitute products which the parties offer.
- **Why change?**
  - HMT can lead to adoption of ‘unrealistic’ product markets in differentiated product markets – new approach should lead to markets which industry participants recognise.

## Less emphasis on market definition?(2)

- Has the need to define the relevant market been abandoned?
- **No – remains important step in our analysis: defines a boundary for the competitive effects analysis including areas of overlap and active rivals**
- **HMT and unilateral effects ask very similar questions:**
  - HMT asks: if there was a merger between Firm A and Firm B, would a price rise of 5% be profitable (absent entry)?
  - Unilateral effects analysis asks: if there was a merger between Firm A and Firm B, would the merged entity have the ability, on its own (unilaterally), to raise prices (absent entry)?
- **However, the Guidelines seek to re-focus assessment on the second question. Why?**
  - ultimately we are seeking to assess whether the merger will impact competition and rivalry
  - in some cases, it makes sense to evaluate evidence drawn from market definition analysis (e.g. demand-side and supply-side substitution) through the lens of analysing direct effects of the merger (see *Travis Perkins / BSS*)

# What about market share thresholds?

- **Guidelines state that:**

- *“the Authorities will not normally have regard to market share and concentration thresholds on anything other than the narrowest market that satisfies the hypothetical monopolist test” (para 5.2.3).*

## What does this mean in practice?

- **Undifferentiated product markets**

- Market shares may be probative
- OFT less likely to have concerns below 40% in undifferentiated product markets where based on narrowest market satisfying HMT (see para. 5.3.5)

- **Differentiated product markets:**

- market shares useful indicator only
- not determinative and no thresholds or presumptions apply in these cases.

## Unilateral effects: what the guidelines say

- **For differentiated product markets the Guidelines state:**
  - *“where products are differentiated, for example by branding or quality, unilateral effects are more likely where the merger firms’ products compete closely. To assess whether the merger results in unilateral effects, the Authorities may analyse the change in the pricing incentives of the merger firms created by bringing their differentiated products under common ownership or control” (para 5.4.6)”*
  - *“Unilateral effects may arise because a price increase becomes less costly when the products of the two firms are brought under common ownership or control. Without the merger, it is costly for one of the merger firms to raise its prices because it will lose the profit on diverted sales as a result. The cost is composed of two elements:*
    - *The profit on lost sales from customers who switch to the products of the other merger firm; and*
    - *The profit on lost sales from customers who switch to the products of firms other than the other merger firm (para 5.4.7)”*
- **For undifferentiated product markets – (see paras 5.4.4 – 5.4.5)**
  - No substantive change – market is concentrated, few firms in the market post-merger, large market share, no fringe of strong competitors, elimination of a strong rival etc. = SLC / cause for concern absent mitigating evidence on entry, buyer power, efficiencies

## Analysis of unilateral effects: in practice

### What does this mean for OFT's assessment of differentiated product mergers?

- In general, three inter-related factors will be assessed for horizontal unilateral effects arising in differentiated product markets (see para 5.4.9). To assess the basic intuition behind the way we assess unilateral effects, let's take a merger between Firm A and Firm B who both sell high spec branded motorcycles:
- Closeness of substitution/competition – if Firm A and Firm B's motorcycles are close (in terms of characteristics: specification, branding, appeal) then it is more likely that the merged firm will capture sales lost in response to a price increase, this makes a post-merger price rise less costly;
- Variable profit margins – (sales revenue minus direct costs of sales) if Firm A and Firm B achieve high profit margins on sales of their motorcycles then unilateral effects are more likely because there is simply more to gain from a price rise even taking into account the fact that some sales will be lost;
- Price sensitivity of customers – if Firm A and Firm B's motorcycle customers are feckless, reckless big spenders who care about the product not the price, that is, if their customers are insensitive to changes in price, then unilateral effects are more likely because the price rise will not lead to many lost sales, making a post-merger price rise less costly.
- Supply-side responses will also be considered: will rival Firm C be capacity constrained? Will Firm D seek to raise prices as well. If answer is "yes" then these factors may make unilateral effects more likely.

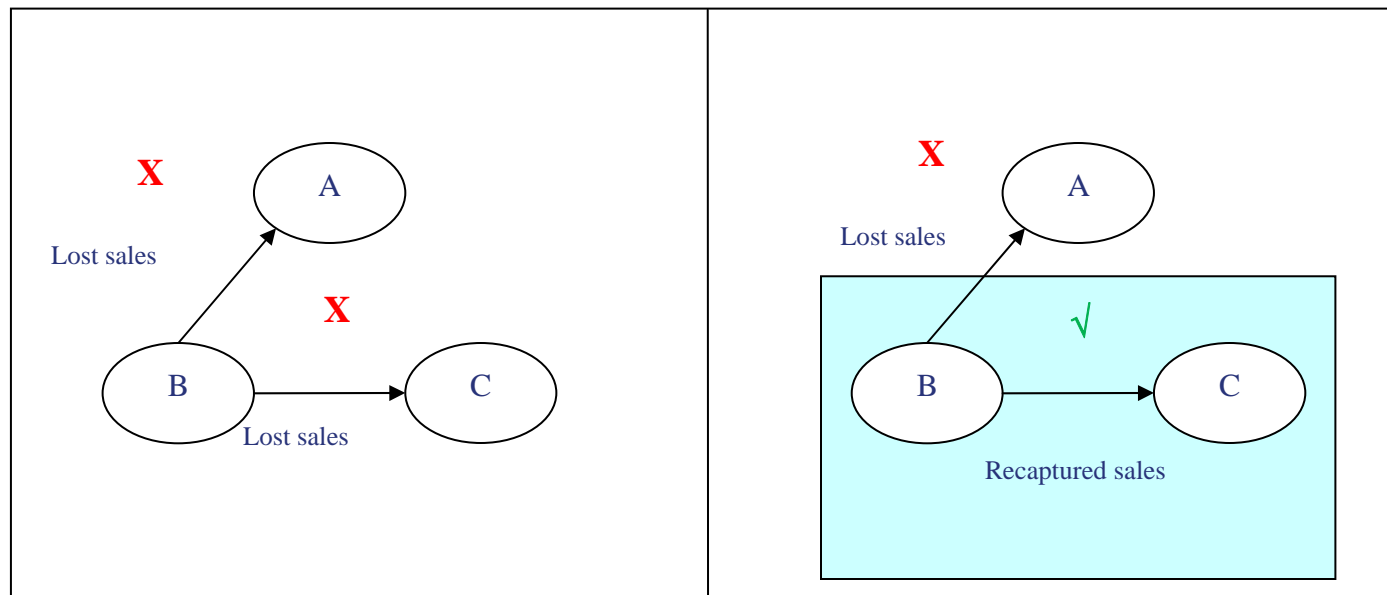
## Evidence sought for unilateral effects analysis

### What evidence will the OFT seek in assessing unilateral effects?

- In practical terms, the OFT will seek/use evidence on:
  - Diversion ratios
    - provide an indication of closeness of substitution between the parties' products (see next slide)
  - Profit margins
    - provide an indication of the extent of customer's sensitivity to changes in price
  - Qualitative evidence (business documents, third party responses)
    - often critical in assessing unilateral effects especially in relation to closeness of competition and customer switching / price sensitivity

## Focus on unilateral effects analysis: diversion ratio

- Panel 1: Effects of price rise by B when A, B and C are independent
- Panel 2: Effects of a price rise by B following a merger with C



## Focus on unilateral effects: presumptions?

### Use of evidence on diversion ratios and margins

- **Each merger is assessed on a case by case basis but:**
  - if it is established that profit margins are high and/or
  - it is established that the diversion ratio is high, then
  - OFT may consider this to be *prima facie* evidence of closeness of competition which may lead to an SLC in the form of price increases or worsening of the competitive offer (see para 5.4.9(b); also *HomeRetail/Focus* (OFT); *GXS/Inovis* (OFT)).
- **OFT may then assess:**
  - the extent of closeness between the parties (often by reference to qualitative and third party evidence). (Note: qualitative evidence may also provide *prima facie* evidence of concern especially where it shows that the parties are each other's closest rivals in the market)
  - supply-side reactions (e.g. extent to which other rivals may counter price rises or extent of closeness of substitution of rivals to the merged parties' offering) and
  - countervailing factors such as entry, buyer power and efficiencies.

# Unilateral effects analysis: some practical challenges

## What are the practical challenges?

- **Diversion ratios – based on survey evidence, event analyses, win/loss data**
  - Challenge: not always readily obtainable at Phase I / time constraint.
- **Margins – ordinarily obtained from management and financial accounts**
  - Challenge: data available on profit margins can vary from firm to firm / defining what costs are 'variable' and over what time period
- **Qualitative evidence – business documents, third party evidence):**
  - Challenge: availability of evidence

## Unilateral effects analysis: use of quantitative indicators (1)

- **A debate raging amongst competition specialists (mainly, economists) is the use of simple quantitative indicators:**
  - Fancy acronyms like: GUPPI, UPP (Upward Pricing Pressure), IPR (Illustrative Price Rises).
  - Less scary than they look – they just seek to combine diversion ratios and profit margins to provide an indication of pricing pressure or price increases post-merger
- **OFT and CC has used these measures in a number of cases (especially retail merger cases): Zipcar/Streetcar (CC); Somerfield/Morrisons (CC); Sports Direct/JJB Sports (CC); Cineworld/Showcase Cinema (OFT); Asda / Netto (OFT); Co-op/Somerfield (OFT).**
- **US horizontal merger assessment guidelines (published 2010) also refer to the possible use of such measures to provide an indication of concern.**

## Unilateral effects analysis: has anything changed?

- **Change? Yes (and no) –**
  - Basic framework for analysis remains the same: i.e. Authorities will assess mergers on the basis of quantitative and qualitative evidence drawn from their investigation.
  - However, Guidelines do reflect a shift from market share presumptions to direct analysis of competitive effects.
- **OFT (and the CC) still assesses impact of countervailing factors:**
  - Barriers to entry and expansion (see section 5.8, Guidelines)
  - Buyer power (see section 5.9, Guidelines)
  - Efficiencies (see section 5.7, Guidelines)

## Counterfactual – OFT’s cautious approach

- **The OFT and CC have different approaches to the counterfactual:**
  - OFT rarely departs from a counterfactual based on “*the pre-merger prevailing conditions of competition*” – adopts a cautious approach consistent with its realistic prospect test;
  - the CC will adopt the counterfactual most appropriate to the case (it is ‘determinative’). (para 4.3.5 and 4.3.6)

### What does this mean in practice?

- **‘Exiting firm’: OFT asks three questions (para 4.3.8):**
  - Whether the firm would have exited (through failure or otherwise)
  - Whether there would have been an alternative purchaser for the firm or its assets to the acquirer under consideration; and
  - What would have happened to the sales of the firm in the event of its exit.

## Counterfactual – exiting firm scenario

- **Economic crisis has led to reasonably few exiting firm applications but some recent cases have raised some interesting issues:**
  - Parties may prove financial difficulty but limb (1) will generally not be satisfied where decisions on exit may have been influenced by the merger
  - Note: the Guidelines state that, the OFT will place more weight on evidence that has not been “prepared in contemplation of the merger” (see para 4.3.9).
  - OFT will be cautious in applying rules to ‘failing divisions’.
  - If you ‘pass’ limb (1), limb (2) is a pretty difficult hurdle. Parties often fail to demonstrate that they ‘shopped’ the target business or assets around to a wide set of potential acquirers.
- **Recent interesting cases on counterfactual which reflect above principles: *Dorf Ketal/Johnson Mathey; Stena/DFDS.***

## New exceptions guidance: modifies approach to *de minimis*

- OFT's 'Exceptions Guidance' published October 2010. If OFT has a duty to refer to the CC, it may consider whether to apply one of the exceptions to the duty to refer.

### What are the main changes?

- De minimis is likely to be applied (absent exceptional factors) where size of market is < £3m (see *Towers Watson/EMB*).
- Cost/benefit analysis undertaken: where size of the market between £3m and £10 (see *Dorf Ketal / Johnson Mathey; Idox/Grantfinder*).
- Relevant customer benefits – expanded section in Exceptions Guidance:
  - EA02 provides (s30(1)) that efficiencies in the form of lower prices, higher quality or greater choice of goods or services can be taken into account as 'relevant customer benefits'. Exception has never been applied
  - Recent case *Ordnance Survey / LGID* discusses exception. Ultimately exception not applied in case BUT evidence on *direct cost savings* resulting from the merger were taken into account when conducting cost-benefit analysis under *de minimis* exception.

## Look ahead: proposed CC/OFT merger – implications for merger control?

- Government intends to consult on proposals to reform the UK competition regime including the merger of the OFT and CC
- Good opportunity to reform the UK competition system and gain the benefits of a merged competition agency

### What are the potential implications for UK merger control?

- Too early to be definitive but key consultation questions likely to include:
  - Should UK move to a mandatory pre-notification system of merger control? OR
  - Can we improve the current UK voluntary system of merger control?
  - Can we find ways to streamline merger control process?
  - ‘Firm’ exemption for small mergers?
- There will be plenty of time to debate all of these issues....

**Thank You.**